

DOW THEORY LETTERS INC.

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Letter 542

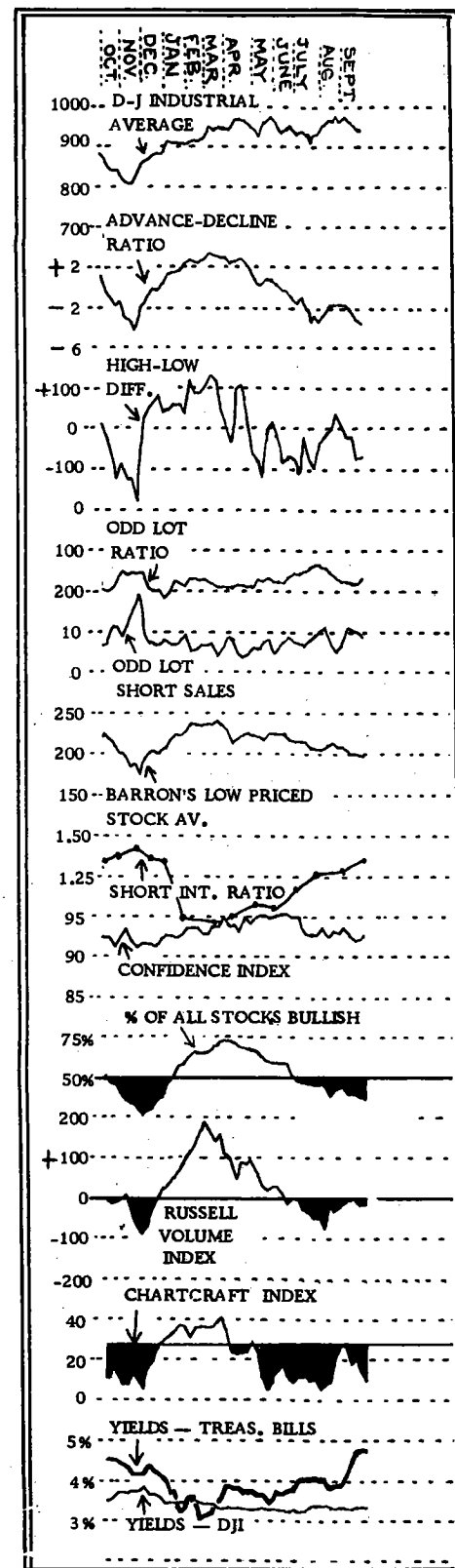
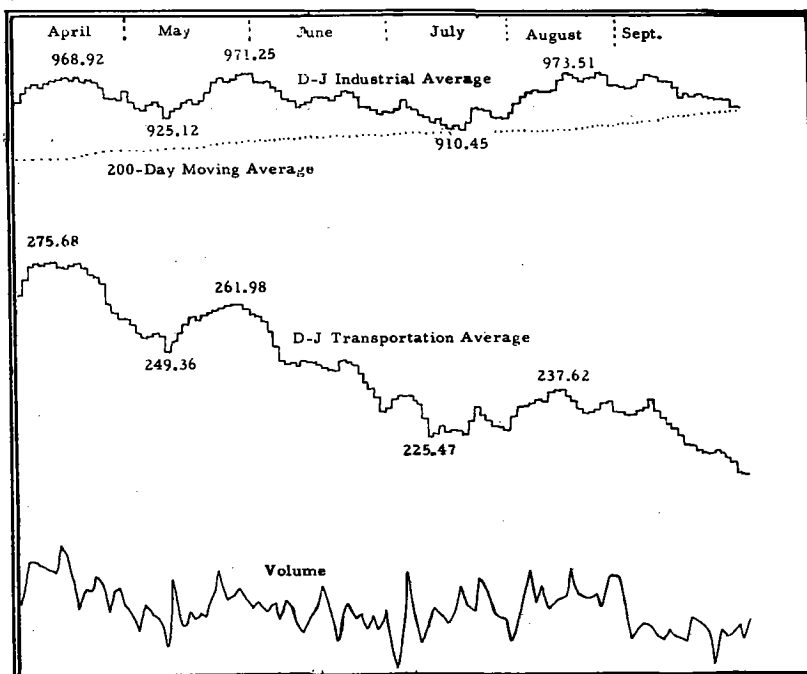
Sept. 22, Dow 943.03, PTI 942, A-D ratio - 3.72

THE MARKET: Throughout 1972 I have been running an advertisement in Barron's which is captioned, "Track of the Bear." Except for the Holt Advisory, I don't think anyone else has taken the bearish position via an ad in a national publication. My friend, E. George Schaefer, has steadfastly insisted that a primary bear market is in force, and a handful of analysts and students across the nation also hold this view. Aside from that, I would say that almost everyone else is bullish, neutral, or isn't thinking in terms of the big picture at all. (Thought: whatever happened to Merrill Lynch's "stampeding-bull" ad?).

I know that the great majority of my subscribers must agree with me; I can tell by the level of subscriptions here. When the boardrooms are thin or empty and subscriptions keep coming in at high levels, I know that I have (1) been right, or (2) given subscribers profitable advice, or (3) helped subscribers avoid painful losses.

It's a strange commentary on human nature that no one is more enthusiastic than a man who has sold out at or near the top of an advance and then stayed out of a primary bear market. Such a fellow is far more enthusiastic than a man who has bought and held through a bull market. Why? Because when a bull market is raging, there are always a lot of people who are "in" — and boring friends at cocktail parties with stories about their paper profits. But when a bear market is on, it is rare to find an investor who has sold out and avoided the crushing losses. Such a man feels that he has bucked the crowd, the "geniuses," the advisors and the propaganda. He has used his head and has saved himself. He has stood alone and been correct.

With those thoughts out of the way, I want to say that I have had another matter on my mind. Looking over my charts and statistics, studying the precarious margin position and the great distributions of 1971 and 1972, I am wondering if we are not moving to the edge of a great tragedy. What looks ominous to me is



Page 2 the advance-decline studies (about which I have written more than any other service), the steady and sizeable list of new lows, the unabated downside pressure, the erosion, and the ever present possibility of a mounting crescendo of margin calls.

I have been writing about the thin margin situation in the last few Letters, and I might as well point to one other ramification. The quality of security credit is currently very, very poor. The accompanying chart (from Research Dept., NYSE) pictures just what the credit quality looks like. At the beginning of 1969 (left side of the chart) about 28% of all margin credit was in a weak position. By "weak" I mean with equity under 60%. But today (right side of the chart) the weak position or under-60% equity constitutes 72% of the total. And that, frankly stated, is not good.

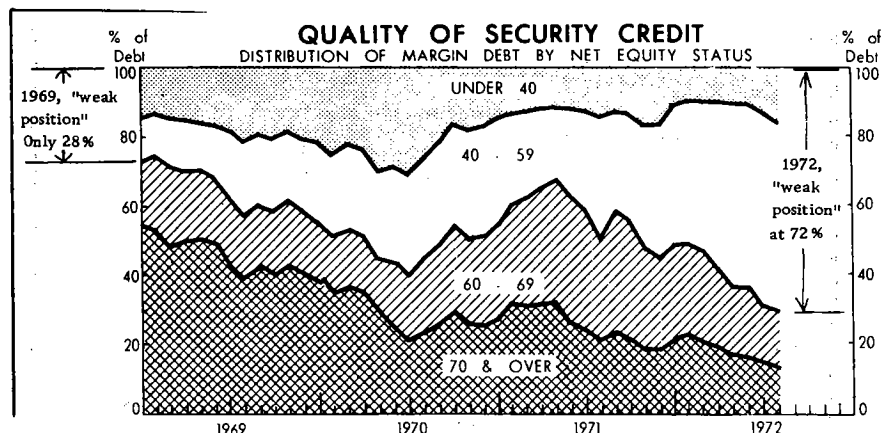
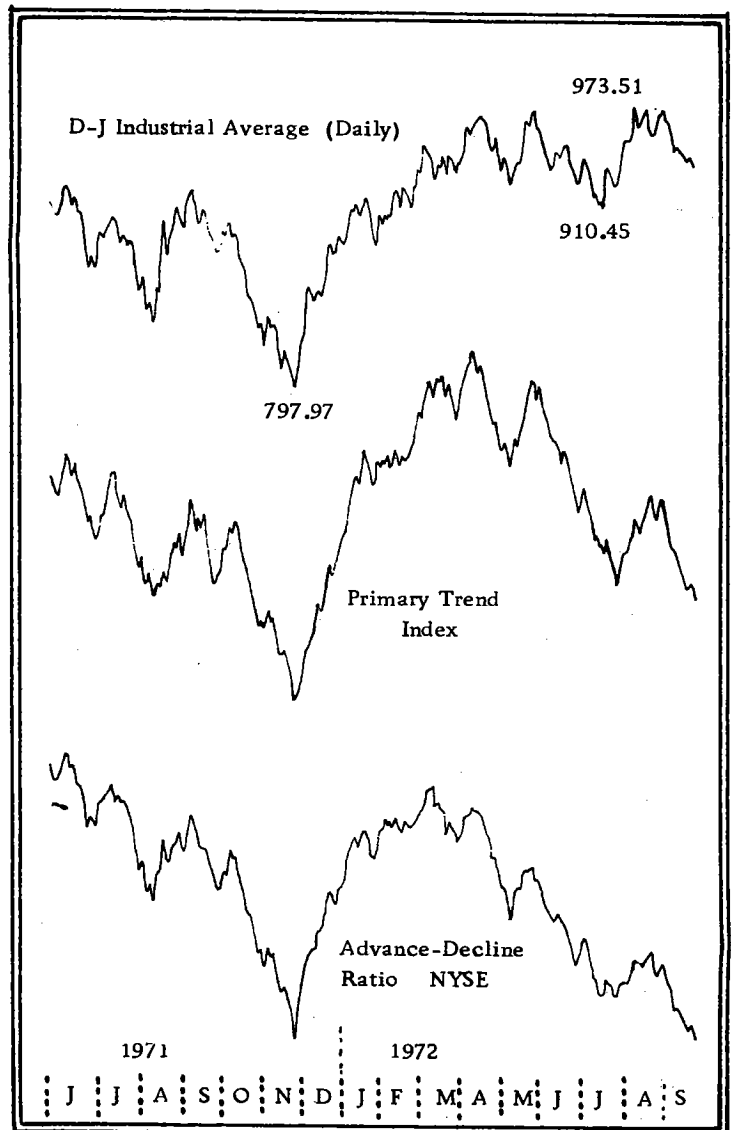
From the standpoint of market vulnerability, the indicator to watch (and we have been watching this all along) is the advance-decline ratio. As the A-D ratio declines (see chart) it is axiomatic that the list of daily new lows expands. Currently, about 25% of all NYSE issues are under their 1971 (yes, 1971) lows, while roughly 40% are near or below their 1972 lows. This means that the broad market situation is becoming rather precarious. We are, as I have pointed out numerous times before, skating on thin ice.

Turning to the daily chart on this page, we see the Dow, the Primary Trend Indicator (PTI), which is a compilation of eight different technical measures, and the Advance-Decline ratio, which gauges the advancing or declining tendencies of all NYSE issues.

On September 12 the A-D ratio broke below its July 31 low point, thereby sinking to a new low for 1972. Five trading days later, on September 20, the PTI confirmed by plunging below its own July 31 low, also dropping to a new low for the year. I take the new low on the PTI to indicate that the technical situation on the NYSE has broken down badly. The PTI had every chance to hold above its late July low. It could not. I consider the new low on the A-D ratio to mean that the great majority of stocks are now in important trouble. They topped out during 1971 and 1972, and the new A-D low merely points to their continuing downside erosion, and the fact that the erosion is now the worse since November, 1971.

From the standpoint of Dow Theory, we can refer to the page 1 chart. In the last Letter I noted that all during the advance from the November, 1971, lows, it was the Transportation Average which led the way. But since the April 12, 1972, Transportation peak of 175.71, it has been the carriers which have also led the market down.

The last confirmed lows (joint lows recorded by both Averages) occurred in July, with Industrials at 910.45 and Transports at 225.47. Transports penetrated their July low a few weeks ago — on September 11. From a Dow Theory standpoint, it is up to Industrials to either confirm the downtrend by



breaking 910.45, or to resist the bear by holding stubbornly above the 910.45 point. I feel that an Industrial penetration of 910.45 will be followed by a rapid descent below 900, a quickening of margin calls, and constitute a danger signal of the first magnitude. On the other hand, a steady refusal by Industrials to break 910.45 could set the stage for what I suppose would be termed "a pre-election rally."

I want to mention something about earnings and price-earnings ratios. At present, there seems to be a veritable chorus of enthusiastic voices, all tuned in to the thesis that the Dow's earnings will be up around \$70 in 1973. My answer is, "So what, the market knows this as well as the analysts do." But what is forgotten is that price-earnings are made by market psychology — what people will pay for earnings.

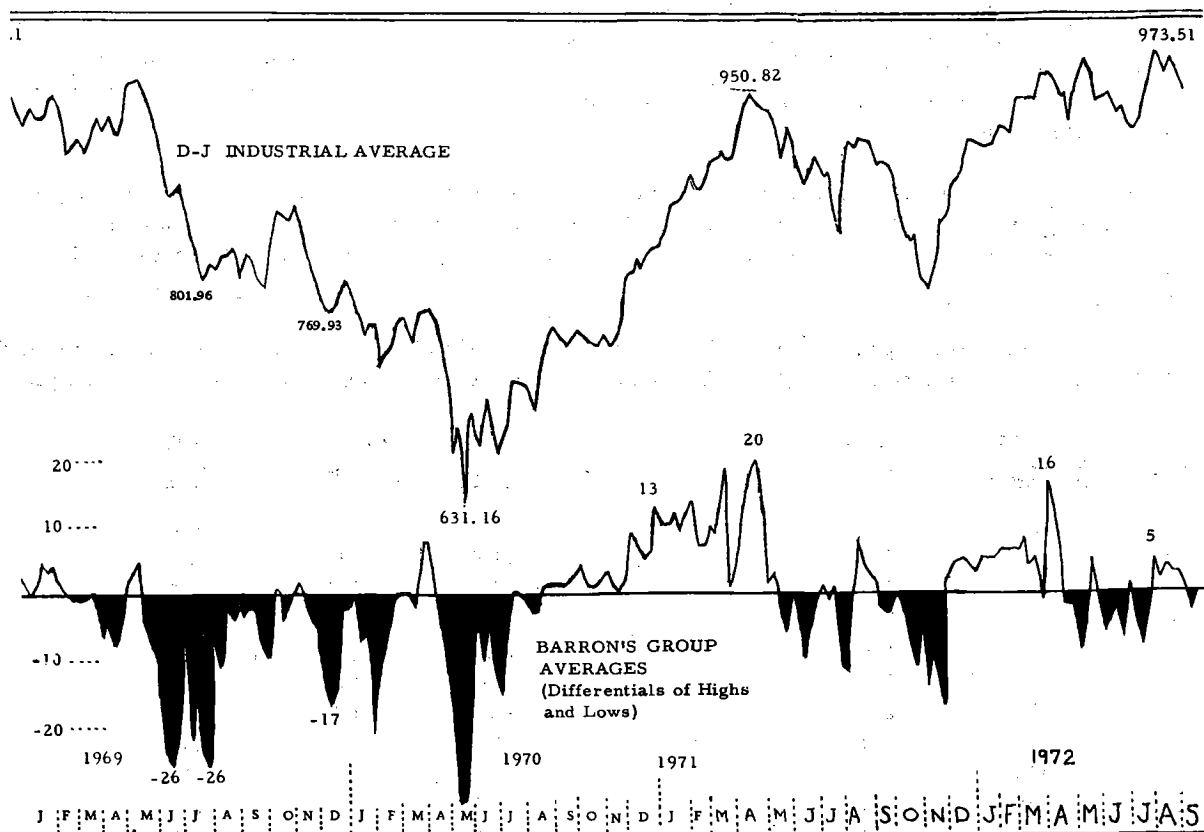
The price earnings ratio for the Dow was as low as 7 in the depressed era of 1949 (just before the greatest boom in history, by the way). And price-earnings ratios got as high as 24 in 1961. At 1949's figuring, \$70 of earnings could put the Dow at 490. At 1961's figuring, \$70 of earnings could put the Dow at 1680. So tabulating the earnings of the Dow is hardly a sure way to figure whether "the market" is going up or down. You'd be far better off trying to figure next year's market psychology! Or to put it another way, "Don't tell me what the Dow is going to earn, tell me what people are going to pay for the earnings."

GROUPS: The group high-low index is one I use to gauge the relative strength or weakness of the market, particularly at critical high and low points. This index is of easy construction. Each week Barron's 34 stock groups are checked for new highs or lows (golds, which are counter-cyclical, are excluded). The differentials are used and charted. For instance, if on a given week there are 6 new highs and 2 new lows, a plus 4 is entered on the chart. It is as simple as that.

Note that at the Dow high of 950.82 recorded in April, 1971, the group index rose to 20. From there the market declined with the Dow touching 797.97 in November, 1971. At the November low the group index dropped to minus 17.

A new advance got underway. On the week ending April 10, 1972, with the Dow closing at 962.60, the group index rose to a peak of 16. That proved to be the high point. In late April the index dropped into minus territory, then climbed to plus 5 in May. During June and July the index again turned negative, and during August, with the Dow establishing recovery highs above 970, the index managed to climb to a feeble plus again.

On the week ending September 15 the index sank to minus 3, its fourth descent into negative territory during 1972. Compare



Page 4 the current and recent action of the index with its action during the 1968 and early 1971 tops. The action during this month and last is undoubtedly some of the poorest on the record.

LONG-TERM BREADTH STUDY: This is a study which last appeared in Letter 535. What this chart shows is the total advance-decline situation on the NYSE over the last 30 weeks. It is tabulated as follows: Each week the differential of the weekly advances and declines is entered (these are the weekly figures from Barron's), and a 30-week moving average of these figures is computed. The moving average is what appears on the chart.

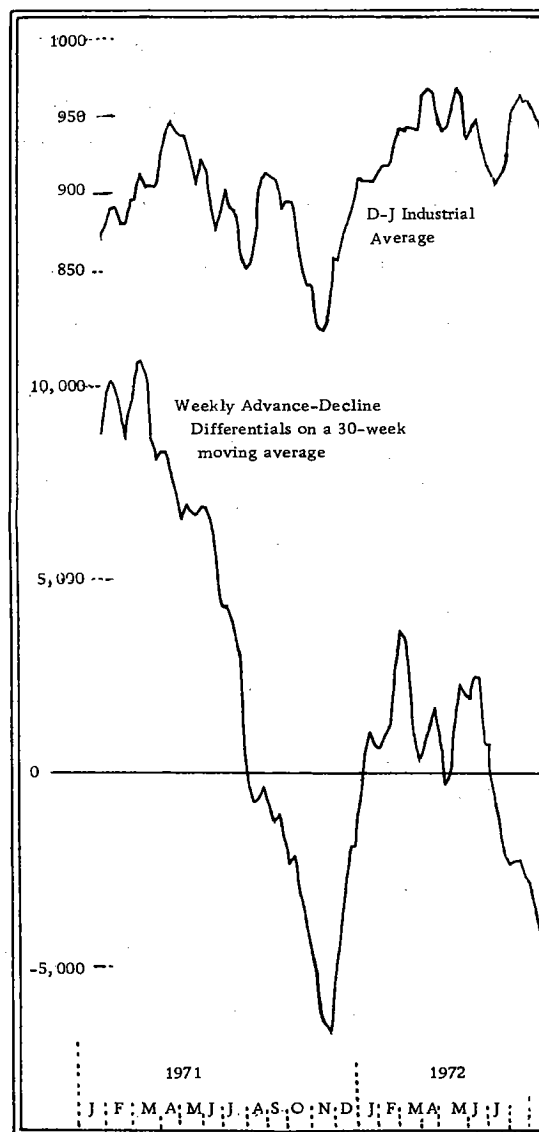
Thus the chart shows two things: (1) The net differential of all weekly advances and declines for the past 30 weeks, (2) the trend of those differentials. Any large portfolio of stocks would tend to follow this long-term index. In other words, if the portfolio was purchased when the index was above zero, that portfolio would show paper losses when the index dropped below zero. If the index was declining, the paper losses would be tending to increase. The converse is obviously true if the portfolio were purchased in an advantageous area and the index was rising.

The chart is now telling us that March, 1971, represented the peak for the majority of stocks on the rise from the 1970 lows. Following the March peak in the long-term A-D index, we had a long decline to the November, 1971, low. A sharp rally ensued, taking the index to the March, 1972, peak (note that this peak was far below the 1971 peak). And since March, 1972, the index has again headed down.

On the week ending July 14, 1972, the index dropped decisively below the zero level (see chart), and the index has been sinking lower ever since. The implications are clear: The advance-decline differentials over the past 30 weeks are now deep in the minus column, and the direction of breadth is still down. The only incredible factor is that so much damage could have been done to so many stocks with the Dow Industrial Average still hovering in the general area of its 1972 recovery high. What this extraordinary phenomenon means will ultimately be made clear. In the past, a persistent cave-in in the A-D ratio has always carried everything with it.

1972 RANGE: I have not seen a word written about this, but the range of the Dow Industrials during 1972 is shaping up as one of historically narrow proportions. The fact is that so far in 1972 we have seen a high of 973.51 and a low of 889.15, a difference of 84 points. This is the narrowest actual point range for the Dow since the 59 point range of 1956 (of course, 1972 is not over yet).

Even more striking, the restricted 84 point range of 1972 represents a movement of 8.6%. To arrive at that figure I divided the peak price (973) of 1972 by the points traveled (84). This is the lowest percentage on the record going back to the year 1919!



YEAR	RANGE IN POINTS	RANGE IN %	YEAR	RANGE IN POINTS	RANGE IN %
1972	84	8%	1960	119	17%
1971	153	22%	1959	105	15%
1970	211	25%	1958	147	25%
1969	199	20%	1957	101	19%
1968	160	16%	1956	59	11%
1967	157	16%	1955	100	20%
1966	251	25%	1954	125	31%
1965	129	13%	1953	38	13%
1964	125	14%	1952	36	13%
1963	121	16%	1951	37	13%
1962	191	26%	1950	39	16%
1961	124	17%	1949	39	18%

September 29, 1972

I list on the bottom of page 4 the tabulations going back to 1949 with all yearly ranges for the Dow and all ranges as a percentage based on peak price for the year (peak price divided by range).

What does the historically narrow Dow range of 1972 imply? My own feeling is that the whole year, so far, can be likened to a Dow "line" or a narrow area in which supply and demand are almost in equilibrium. As a rule, true lines entail narrow fluctuations in both Averages, and a glance on the page 1 chart will show that while Industrials have been held to a virtual standstill, the Transports have been going steadily down since April. The question then becomes, have Industrials been accumulated or distributed within their narrow 1972 range?

There is obviously no arbitrary answer to this question. Studying the tabulation of previous years, it is of some interest that the two previous lowest percentage fluctuations were the 13% range of 1965 and the 11% range of 1956. In retrospect we now know that those years included much distributive action in stocks.

The year 1966, following the narrow 1965 year, took the Dow only 26 points over its 1965 high, and then a major collapse hit the stock market. The year 1957, following the narrow Dow fluctuations of 1956, saw the Dow fail to better the 1956 peak. In the latter part of 1957 the market was subject to a severe cave-in, followed by an equally severe economic recession.

THOUGHTS: Last week I was reading a well-known market commentary written by a highly intelligent man, and I came upon the sentence, "Nevertheless, we agree with the US Treasury that ultimately gold will be replaced as the common denominator of the monetary system." That statement started me thinking many thoughts.

Men have a great deal of trouble submitting their will to a superior power. One of the main themes (occurring over and over again) in the Bible is the refusal of men to give up what they "want" and move in the direction which God wants them to go. They will not submit to God's power. God gives them what they need, seldom what they want. It is a story of man's self-interest as against God's wish for man to advance towards love, truth and understanding.

Again and again we see the rise of great nations, the gathering of power, the great opportunities, and then somehow the collapse in morality, the signs of decay (always accompanied by inflation), the arrogance which takes the place of true passion, and ultimately the collapse as the sands of time relegate the once-great nation to a chapter in the history books.

I have often wondered why great nations do not endure, but great religions do. For instance, Judaism and Christianity have lasted for thousands of years but where are Rome, Greece, Persia, Syria, the Turkish Empire? The difference is that the great religions are built on passion and humility and a submission of man's will to the greater will of a supreme being. The great nations were built on man's preoccupation with his own strength, his greed, his belief in his own power to direct his personal destiny.

Many of these same observations, I believe, apply to money. Man wants to be master of money, he wants to make money his slave. Man does not want money to have a power of its own, and he does not want to submit to the ultimate law of value. That is the basic reason why powerful politicians and businessmen hate gold. The power of gold has always been immutable. Kings die, kingdoms decay, civilizations pass away, and men dig in the tombs for the gold left by those that have fallen before. The names are forgotten but the value of the gold which they left has only increased. Whose power endures then, the tyrant or the gold that he left behind?

The truth is that gold has a value outside the scope of man. Gold is, in a strange way, a law unto itself. Every paper money in history could be expressed in terms of how much of it was needed to purchase an ounce of gold. Franz Pick once wrote that all paper money is ultimately debased. Nothing like this has ever been said of gold.

Today the politicians have stopped trying to debase gold, they have a new slogan. Gold is needed for a thousand commercial uses, let's keep it in commerce where it is in short supply, but let's get it out of the monetary system.

The latest US fantasy is that SDR's will replace gold in the international sphere, and Treasury Secretary Schultz presented the whole American dream to the IMF on September 26. The members listened politely, because it's pre-election, and no one wants to upset the applecart at this time. But Europe has the gold now, having purchased as much as they could from the US at the great bargain price of \$35 per ounce. Now the US is telling Europe that gold is a "relic" and should be dispensed with in favor of international paper credits. "Dream on, Uncle Sam, dream on" is the unspoken thought that must cross the IMF members' minds. Meanwhile, politeness reigns.

I talk about perspective and long-range charts, I'm not just mouthing Wall Street platitudes. This office has recently been working on an annual chart of the Dow Industrials going back in most cases half a century, to the year 1924! The results have, to put it mildly, been fascinating.

Have you ever seen an annual chart of General Motors (or any other stock) going back to the year 1924? I hadn't either until we put one together here. The accompanying chart shows the yearly high-low range of GM scaled to semi-logarithmic proportions so that all movements can be properly compared. And those comparisons are well worth studying.

For instance, note the unbelievable rise in GM from 1924 to 1929. The rise, when viewed in terms of percentages, is something to see — as was the decline of 1929-32. Again, the advance from 1932 to 1937 in GM was little short of amazing, and this was followed by the 1937 bear market and the powerful base built between 1939 and 1942.

From there (1942), GM embarked on an advance which held intact (on a trendline basis) to 1966, a period of 24 years. From 1966, where the current very deceptive bear market started, to the present, GM has been plotting a lateral range. There has been less movement in GM (in percentages) over the past decade than any time in previous GM history.

One conclusion which shows up very clearly on this chart: The movements of GM have, over the past 48 years, closely followed the profile of the "market". At certain periods, such as 1924 to 1929, 1929 to 1932, the entire 1932-40 era, GM was capable of very wide swings as was the market. At such times, the usual concepts of "overbought" and "oversold" fell by the wayside. That is one reason why I always feel a twinge of skepticism when the market rallies or declines 5% or 10% and a chorus of Wall Street analysts start chanting that we are "oversold" or "overbought." Maybe we are, but in certain periods the rules change. As William Hamilton, great editor of the Wall Street Journal once said, "Pride of opinion has broken more men on Wall Street than anything else." Pride of opinion, translated into the language of the market analysts, could read "dogmatism."

